



[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-157714-06]

RIN 1545-BG43

Determination of Governmental Plan Status

AGENCY: Internal Revenue Service (IRS), Department of the Treasury.

ACTION: Advance notice of proposed rulemaking.

SUMMARY: The Treasury Department and IRS anticipate issuing regulations under section 414(d) of the Internal Revenue Code (Code) to define the term “governmental plan.” This document describes the rules that the Treasury Department and IRS are considering proposing relating to the determination of whether a plan is a governmental plan within the meaning of section 414(d) and contains an appendix that includes a draft notice of proposed rulemaking on which the Treasury Department and IRS invite comments from the public. This document applies to sponsors of, and participants and beneficiaries in, employee benefit plans that are determined to be governmental plans.

DATES: Written or electronic comments must be received by **[INSERT DATE 90 DAYS AFTER PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**.

ADDRESSES: Send submissions relating to the section 414(d) draft general regulations to: CC:PA:LPD:PR (REG-157714-06), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington DC, 20044. Submissions may be hand delivered Monday through Friday, between the hours of 8 a.m. and 4 p.m. to

CC:PA:LPD:PR (REG-157714-06), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC.

Alternately, taxpayers may submit comments relating to the section 414(d) draft general regulations electronically via the Federal eRulemaking Portal at www.regulations.gov (IRS-REG-157714-06).

FOR FURTHER INFORMATION CONTACT: Concerning the ANPRM, Pamela R. Kinard, at (202) 622-6060; concerning submission of comments, Richard A. Hurst, at Richard.A.Hurst@irscounsel.treas.gov or at (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document describes rules that the Treasury Department and IRS are considering proposing and contains a draft notice of proposed rulemaking (in the Appendix to this ANPRM) under section 414(d) of the Internal Revenue Code (Code). Under the draft notice of proposed rulemaking (in the Appendix to this ANPRM), the rules would provide general guidance relating to the determination of whether a retirement plan is a governmental plan within the meaning of section 414(d) (section 414(d) draft general regulations). The principles described in this ANPRM could also apply for purposes of certain parallel terms in sections 403(b) and 457 of the Code.

Section 414(d) of the Code provides that the term "governmental plan" generally means a plan established and maintained for its employees by the Government of the United States, by the government of any State or political subdivision thereof, or by any agency or instrumentality of any of the foregoing. See sections 3(32) and 4021(b)(2) of the Employee Retirement Income Security Act of 1974 (ERISA) for definitions of the

term “governmental plan,” which govern respectively for purposes of title I and title IV of ERISA¹.

The term “governmental plan” also includes any plan to which the Railroad Retirement Act of 1935 or 1937 (49 Stat. 967, as amended by 50 Stat. 307) applies and which is financed by contributions required under that Act and any plan of an international organization which is exempt from taxation by reason of the International Organizations Immunities Act (59 Stat. 669). See section 414(d)(2) of the Code.

Section 414(d) was amended by the Pension Protection Act of 2006, Public Law 109-280 (120 Stat. 780) (PPA '06) to include certain plans of Indian tribal governments and related entities.² Section 906(a)(1) of PPA '06 provides that the term “governmental plan” includes a plan which is established and maintained by an Indian tribal government (as defined in section 7701(a)(40)), a subdivision of an Indian tribal government (determined in accordance with section 7871(d)), or an agency or instrumentality of either (ITG), and all the participants of which are employees of such entity substantially all of whose services as such an employee are in the performance of essential governmental functions but not in the performance of commercial activities (whether or not an essential governmental function).

Neither section 414(d) of the Code, section 3(32) of ERISA, nor section 4021(b)(2) of ERISA define key terms relating to governmental plans, including the terms “established and maintained,” “political subdivision,” “agency,” and “instrumentality.” Currently, there are no regulations interpreting section 414(d).

¹ The three definitions of the term “governmental plan” are essentially the same. The only difference is that, in defining the term “governmental plan,” section 3(32) of ERISA uses the phrase “established or maintained,” whereas section 414(d) of the Code and section 4021(b) of ERISA use the term “established and maintained.”

² Section 906(a) of PPA '06 made similar amendments to sections 3(32) and 4021(b)(2) of ERISA.

Revenue Ruling 89-49 (1989-1 CB 117), see §601.601(d)(2), sets forth a facts and circumstances analysis for determining whether a retirement plan is a governmental plan within the meaning of section 414(d).³ This analysis is used by the IRS in issuing letter rulings.

Governmental plans are subject to different rules than retirement plans of nongovernmental employers. Governmental plans are excluded from the provisions of titles I and IV of ERISA. In addition, governmental plans receive special treatment under the Code. These plans are exempt from certain qualification requirements and they are deemed to satisfy certain other qualification requirements under certain conditions. As a result, the principal qualification requirements for a tax-qualified governmental plan⁴ are that the plan--

- Be established and maintained by the employer for the exclusive benefit of the employer's employees or their beneficiaries;
- Provide definitely determinable benefits;
- Be operated pursuant to its terms;
- Satisfy the direct rollover rules of section 401(a)(31);
- Satisfy the section 401(a)(17) limitation on compensation;
- Comply with the statutory minimum required distribution rules under section 401(a)(9);

³ See also Rev. Rul. 57-128 (1957-1 CB 311), see § 601.601(d)(2), which provides guidance on determining when an entity is a governmental instrumentality for purposes of the exemption from employment taxes under section 3121(b)(7) and 3306(c)(7).

⁴ A special rule applies to contributory plans of certain governmental entities. Section 414(h)(2) provides that, for a qualified plan established by a State government or political subdivision thereof, or by any agency or instrumentality of the foregoing, where the contributions of the governmental employer are designated as employee contributions under section 414(h)(1) but the governmental employer picks up the contributions, the contributions picked up will be treated as employer contributions.

- Satisfy the pre-ERISA vesting requirements under section 411(e)(2);⁵
- Satisfy the section 415 limitations on benefits, as applicable to governmental plans; and
- Satisfy the prohibited transaction rules in section 503.

State and local governments, political subdivisions thereof, and agencies or instrumentalities thereof are generally not permitted to offer cash or deferred arrangements under section 401(k). However, an ITG is permitted to offer a cash or deferred arrangement under section 401(k).

For further background, see the “Background” section of the preamble in the section 414(d) draft general regulations in the Appendix to this ANPRM under the headings, “Exclusion of Governmental Plans from ERISA,” “Exemption of Governmental Plans from Certain Qualified Plan Rules,” and “Exemption of Governmental Plans from Other Employee Benefit Rules Relating to Retirement Plans.”

Over the past several years, the IRS has been coordinating with the Department of Labor (DOL) and Pension Benefit Guaranty Corporation (PBGC) (the “Agencies”) on governmental plan determinations. Although the anticipated proposed regulations would only be applicable for purposes of section 414(d), the DOL and PBGC were consulted when drafting this proposal. DOL and PBGC agreed that it would be advantageous for the Agencies and the regulated community for there to be coordinated criteria for determining whether a plan is a governmental plan within the meaning of section 414(d) of the Code, section 3(32) of ERISA, and section 4021(b)(2) of ERISA. See the “Background” section of the preamble in the section 414(d) draft general

⁵ Section 411(e)(2) states that a plan described in section 411(e)(1) is treated as meeting the requirements of section 411 if the plan meets the vesting requirements resulting from the application of section 401(a)(4) and (a)(7) as in effect on September 1, 1974.

regulations in the Appendix to this ANPRM under the heading, “Interagency Coordination on Governmental Plan Determinations.”

The Treasury Department and the IRS have determined to seek public comment on the draft proposed regulations in the Appendix to this ANPRM in advance of issuing a notice of proposed rulemaking. In light of the interaction of the governmental plan definitions in the Code and ERISA, a copy of the comments will be forwarded to DOL and PBGC.

Explanation of Provisions

Attached to the Appendix to this ANPRM is a draft notice of proposed rulemaking. The draft regulations include proposed rules, a preamble, and a request for comments. The Treasury Department and IRS invite the public to comment on the rules that the Treasury Department and IRS are considering proposing, which would generally define the term “governmental plan” within the meaning of section 414(d), as well as other key related terms, including “State,” “political subdivision of a State,” and “agency or instrumentality of a State or political subdivision of a State.”

In determining whether an entity is an agency or instrumentality of the United States or an agency or instrumentality of a State or political subdivision of a State, the anticipated guidance would provide a facts and circumstances analysis. The factors used in these analyses are drawn from the factors historically used in governmental plan determinations, including Rev. Ruls. 57-128 and 89-49. The anticipated guidance would provide several examples illustrating the application of the facts and circumstances tests. See the “Explanation of Provisions” section in the section 414(d) draft general regulations in the Appendix to this ANPRM under the headings,

“Definitions of the United States and agency or instrumentality of the United States” and “Definition of agency or instrumentality of a State or a political subdivision of a State.”

See §601.601(d)(2).

The anticipated proposed regulations would include numerous factors for determining whether an entity is an agency or instrumentality of a State or a political subdivision of a State. The section 414(d) draft proposed regulations in the Appendix to this ANPRM would categorize these factors into major factors and other factors. The section 414(d) draft general regulations would also request comments from the public on whether the final regulations should eliminate the distinction between main and other factors. In addition, the section 414(d) draft general regulations would request comments on the ordering and application of main and other factors; for example, whether, as an alternative to the ranking of major factors and other factors, the regulations could provide a safe harbor standard focusing on control and fiscal responsibility under which the entity would be treated as an agency or instrumentality of a State or a political subdivision of a State. For further explanation of the safe harbor standard, see the “Comments and Public Hearing” section in the preamble of the section 414(d) draft general regulations, which is located in the Appendix to this ANPRM.

The anticipated proposed regulations do not address the special rules that apply in determining whether a plan of an Indian tribal government is a governmental plan within the meaning of section 414(d). That topic would be reserved in the proposed regulations and is addressed in an ANPRM (REG-133223-08) that is being published elsewhere in this issue of the **Federal Register**.

The anticipated proposed regulations would provide rules for determining whether a governmental entity has established and maintained a plan for purposes of section 414(d). The anticipated proposed regulations might provide that a plan is established and maintained for the employees of a governmental entity if: (1) the plan is established and maintained by an employer within the meaning of §1.401-1(a)(2), (2) the employer is a governmental entity, and (3) the only participants covered by the plan are employees of that governmental entity. The anticipated proposed regulations might also provide rules covering circumstances involving a change in status of an entity (that is, when a private entity becomes a governmental entity or when a governmental entity becomes a private entity) due to an acquisition or asset transfer. See the “Explanation of Provisions” section in the section 414(d) draft general regulations in the Appendix to this ANPRM under the heading, “Requirements for establishing and maintaining a section 414(d) governmental plan.”

Recognizing that the guidance might affect numerous governmental plan participants and their beneficiaries, the anticipated proposed regulations request comments on transition rules, including transitional relief for governmental plans that permitted participation of a small number of former employees in their plans. See the “Comments and Public Hearing” section in the preamble of the section 414(d) draft general regulations that is located in the Appendix to this ANPRM.

Request for Comments

Before the notice of proposed rulemaking is issued, consideration will be given to any written comments that are submitted timely (preferably a signed original and eight

(8) copies) to the IRS. All comments will be available for public inspection and copying. Copies of the comments will be provided to the DOL and PBGC.

The IRS and Department of Treasury plan to schedule a public hearing on the ANPRM. That hearing will be scheduled and announced at a later date. In addition to a public hearing, the Treasury Department and IRS anticipate scheduling “Town Hall” meetings in order to obtain comments from the public on the section 414(d) draft general regulations. It is expected that these “Town Hall” meetings will take place in different locations across the country. Participants will be encouraged to pre-register for the meetings. Information relating to these “Town Hall” meetings, including dates, times, locations, registration, and the procedures for submitting written and oral comments, will be available on the IRS website relating to governmental plans at <http://www.irs.gov/retirement/article/0,,id=181779,00.html>.

Drafting Information

The principal author of this advance notice of proposed rulemaking is Pamela R.

Kinard, Office of the Chief Counsel (Tax-exempt and Government Entities), however, other personnel from the IRS and Treasury Department participated in its development.

Steven T. Miller,

Deputy Commissioner for Services and Enforcement.

APPENDIX

The following is draft language for a notice of proposed rulemaking that would set forth rules relating to the determination of whether a plan is a governmental plan within the meaning of section 414(d). The IRS and Treasury release this draft language in order to solicit comments from the governmental plans community:

Background

This document contains proposed regulations under section 414(d) of the Internal Revenue Code (Code). These regulations, when finalized, would provide guidance relating to the determination of whether a retirement plan is a governmental plan within the meaning of section 414(d). The definition of a governmental plan under section 414(d) applies for purposes of Part I of Subchapter D of Chapter 1 of Subtitle A (Income Taxes) of the Code (sections 401 through 420) and certain other Code provisions that refer to section 414(d) (such as sections 72(t)(10), 501(c)(25)(C), 4975(g)(2), 4980B(d)(2), 9831(a)(1), and 9832(d)(1)). It is expected that the principles set forth in these regulations would generally also apply for purposes of sections 403(b) and 457.

Statutory Definition of Governmental Plan

Both the Code and the Employee Retirement Income Security Act of 1974 (ERISA) define the term “governmental plan.” Section 414(d) of the Code provides that the term “governmental plan” generally means a plan established and maintained for its employees by the Government of the United States, by the government of any State or political subdivision thereof, or by any agency or instrumentality of any of the foregoing. See sections 3(32) and 4021(b)(2) of ERISA for parallel definitions of the term

governmental plan, discussed under the heading, “Exclusion of Governmental Plans from ERISA.”

The term “governmental plan” also includes any plan to which the Railroad Retirement Act of 1935 or 1937 (49 Stat. 967, as amended by 50 Stat. 307) applies and which is financed by contributions required under that Act and any plan of an international organization which is exempt from taxation by reason of the International Organizations Immunities Act, Public Law 79-291 (59 Stat. 669). Section 414(d) was amended by the Pension Protection Act of 2006, Public Law 109-280 (120 Stat. 780) (PPA '06) to include certain plans of Indian tribal governments.⁶ See Notice 2006-89 (2006-43 IRB 772), see §601.601(d)(2), for guidance relating to plans established and maintained by Indian tribal governments.⁷ These proposed regulations do not provide any guidance concerning the special provisions in section 414(d) relating to the Railroad Retirement Act of 1935 or 1937, the International Organizations Immunities Act, or Indian tribal governments.

Application of Section 414(d)

These proposed regulations are only applicable for purposes of section 414(d), and not for any other purpose under the Code.⁸ However, the section 414(d) definition of “governmental plan” applies for other sections of the Code, including:

⁶ Section 906(a)(1) of PPA '06 provides that the term “governmental plan” includes a plan which is established and maintained by an Indian tribal government (as defined in section 7701(a)(40)), a subdivision of an Indian tribal government (determined in accordance with section 7871(d)), or an agency or instrumentality of either, and all the participants of which are employees of such entity substantially all of whose services as such an employee are in the performance of essential governmental functions but not in the performance of commercial activities (whether or not an essential government function). Section 906(a) of PPA '06 made similar amendments to sections 3(32) and 4021(b) of ERISA.

⁷ See also Notice 2007-67 (2007-35 IRB 467), see §601.601(d)(2) (extending transitional relief for plans of Indian tribal governments to comply with the requirements of section 906 of PPA '06).

⁸ However, as indicated earlier, it is expected that the principles set forth in these regulations would also be taken into account for purposes of sections 403(b) and 457.

- Section 72(t)(10)(A) (exception to the early withdrawal tax for certain distributions from a defined benefit governmental plan);
- Section 457(e)(17) (special rules for: (1) direct trustee-to-trustee transfers from a section 457 deferred compensation plan to a section 414(d) governmental plan in order to purchase permissive service credit under section 414(n)(3)(A) or (2) the repayments of cashouts under governmental plans);
- Section 501(c)(25)(C)(ii) (exempting section 414(d) governmental plans from taxation);
- Section 503(a)(1) (applying the prohibited transactions rules in section 503 to governmental plans as defined in section 4975(g)(2))
- Section 818(a)(6)(A) (defining the term “pension plan contract”);
- Section 1400Q(d)(2)(A)(ii) (special timing rule for section 414(d) governmental plans to make certain conforming amendments);
- Section 4972(d)(1)(B) (exempting section 414(d) governmental plans from the excise tax on nondeductible contributions to a qualified employer plan);
- Section 4975(g)(2) (exempting section 414(d) governmental plans from the prohibited transaction rules of section 4975);
- Section 4980(c)(1)(B) (exempting section 414(d) governmental plans from the tax on the reversion of qualified plan assets to an employer under section 4980);
- Section 4980B(d)(2) (exempting section 414(d) governmental plans from the COBRA requirements under section 4980B);
- Section 4980F(f)(2) (exempting section 414(d) governmental plans from the requirement to provide a notice required under section 204(h) of ERISA);

- Section 6057(c)(2) (providing rules relating to the voluntary submission of annual registration statements by section 414(d) governmental plans); and,
- Sections 9831(a)(1) and 9832(d)(2) (exempting section 414(d) governmental plans from the group health plan requirements).

The definitions and rules also apply for purposes of section 101(h)(1)(A) (special rule exempting governmental plan survivor benefits attributable to service of a public safety officer killed in the line of duty).

Currently, there are no regulations interpreting section 414(d). Neither section 414(d) of the Code nor ERISA defines key terms relating to governmental plans, including the terms “established and maintained,” “political subdivision,” “agency,” and “instrumentality.”

Executive Order 13132

Executive Order 13132 requires that Federal departments and agencies engage in consultation procedures in certain circumstances where regulations are issued which have a substantial direct effect on States. While these regulations when issued as final regulations would not have such a substantial direct effect, the IRS and Treasury Department have followed similar procedures, including issuance not only of these proposed regulations, but also an advance notice of these regulations which was published (date to be provided) in the **Federal Register**.

Judicial Determinations of Governmental Entity Status

Historically, courts have used the test in NLRB v. Natural Gas Utility District of Hawkins County, Tennessee, 402 U.S. 600 (1971), in determining whether an entity is an agency or instrumentality of a State or a political subdivision of a State. In Hawkins

County, the Supreme Court interpreted the term “political subdivision” for purposes of 29 U.S.C. 152(2) (section 2(2) of the National Labor Relations Act (NLRA), as amended by the Labor-Management Relations Act).⁹ Although the Supreme Court in Hawkins County analyzed whether the employer at issue was a political subdivision for purposes of the NLRA, courts use the same analysis for determining whether an entity is an agency or instrumentality of a State or a political subdivision of a State for purposes of ERISA.¹⁰ The two-prong test in Hawkins County analyzes whether the entity has been “(1) created directly by the state, so as to constitute departments or administrative arms of the government, or (2) administered by individuals who are responsible to public officials or to the general electorate.” Hawkins County, 402 U.S. at 604-05. In addition to this two-prong test, the Supreme Court also analyzed other factors, including: whether the utility had broad powers to accomplish its public purpose; whether the utility’s property and revenue were exempt from state and local taxes (as well as whether its bonds were tax-exempt); whether the utility had the power of eminent domain; whether the utility was required to maintain public records; whether the utility’s commissioners were appointed by an elected county judge; and whether the

⁹ 29 U.S.C. 152(2) provides that the term “employer” includes any person acting as an agent of an employer, directly or indirectly, but shall not include the United States or any wholly owned Government corporation, or any Federal Reserve Bank, or any State or political subdivision thereof, or any person subject to the Railway Labor Act, as amended from time to time, or any labor organization (other than when acting as an employer), or anyone acting in the capacity of officer or agent of such labor organization.

¹⁰ “The NLRB guidelines are a useful aid in interpreting ERISA’s governmental exemption, because ERISA, like the National Labor Relations Act, ‘represent[s] an effort to strike an appropriate balance between the interests of employers and labor organizations.’” Rose v. Long Island Railroad Pension Plan, 828 F.2d 910, 916 (2nd Cir. 1987), cert. denied, 485 U.S. 936 (1988) (quoting H.R. Rep. No. 533, reprinted in 1974 USCCAN at 4647). See also, Shannon v. Shannon, 965 F.2d 542, 547 (7th Cir. 1992), cert. denied, 506 U.S. 1028 (1992) (stating that the proper test for determining whether an entity is an agency or instrumentality of a State or political subdivision for purposes of ERISA is the Hawkins test), Koval v. Washington County Redevelopment Authority, 574 F.3d 238, 242 (3rd Cir. 2009) (stating that the Hawkins test is the most fitting analysis for determining whether an entity is a political subdivision), and Brooks v. Chicago Housing Authority, No. 89-C-9304, 1990 WL 103572 at 1, 1990 U.S. Dist. LEXIS 8233 at 3 (N.D. Ill. July 5, 1990) (applying the Hawkins test).

commissioners could be removed by the State of Tennessee pursuant to State procedures for removal of public officials. Many of these factors are similar to the factors used in determining whether an entity is an agency or instrumentality of a State or a political subdivision of a State under these proposed regulations.

In determining whether an entity is an agency or instrumentality of the United States, courts either apply a facts and circumstances analysis or look to the relationship between the entity and its employees. In Alley v. Resolution Trust Corporation, 984 F.2d 1201 (D.C.Cir. 1993), in analyzing whether the Federal Asset Disposition Association (FADA), a savings and loan association established by the Federal Home Loan Bank Board, was a Federal instrumentality for governmental plan purposes, the court focused on the employment relationship between the entity and its employees.¹¹ In looking at the employer-employee relationship, the Alley court concluded that FADA functioned more like a private enterprise than a governmental agency in the area of its employment relations. “Measured by the terms and conditions of their employment, FADA personnel far more closely resembled private sector employees than they did government workers. Like employees of ‘ordinary’ Federally chartered S&Ls, FADA’s employees were outside the civil service system, and were not subject to the personnel rules or restrictions on salaries and benefits imposed generally on Federal employees.”¹²

However, in Berini v. Federal Reserve Bank of St. Louis, Eighth District, 420 F.Supp.2d 1021 (E.D. Mo. 2005), the court reviewed administrative and judicial

¹¹ “We focus our attention . . . on what should be the core concern for ERISA purposes--the nature of an entity’s relationship to and governance of its employees.” Alley v. Resolution Trust Corporation, 984 F.2d at 1206, n. 11.

¹² Alley v. Resolution Trust Corporation, 984 F.2d at 1206.

authority in determining whether an entity is a Federal agency or instrumentality and applied a multi-factor test in determining whether the employee benefit plans maintained by the Federal Reserve System are governmental plans within the meaning of section 3(32) of ERISA. The Berini test was based on the six factors in Rev. Rul. 57-128 (1957-1 CB 311), see §601.601(d)(2), which was also the test applied by the court in Rose v. Long Island Railroad Pension Plan, 828 F.2d 910, 918 (2nd Cir. 1987), cert. denied, 485 U.S. 936 (1988). Factors weighed by the Berini court included that the Federal reserve banks were established directly by Congressional legislation to perform an important governmental function (to increase control of the nation's currency and banking system), the banks exist only by an enabling statute, they possess only the powers granted by the legislation, the private interests involved do not have the typical interests of an owner, and the banks are controlled by the Federal Reserve Board of Governors, which is a governmental agency.¹³

Agency Guidance Regarding Governmental Entity Status

Revenue Ruling 57-128 provides guidance on when an entity is a governmental instrumentality for purposes of the exemption from employment taxes under sections 3121(b)(7) and 3306(c)(7). The revenue ruling lists the following factors to be considered in determining whether an organization is an instrumentality of one or more States or political subdivisions thereof: (1) whether the organization is used for a governmental purpose and performs a governmental function; (2) whether performance of its function is on behalf of one or more States or political subdivisions; (3) whether there are any private interests involved, or whether the States or political subdivisions involved have the powers and interests of an owner; (4) whether control and

¹³ Berini v. Federal Reserve Bank of St. Louis, 420 F.Supp.2d at 1026-29.

supervision of the organization is vested in public authority or authorities; (5) whether express or implied statutory authority or other authority is necessary for the creation and/or use of such an instrumentality, and whether such authority exists; and (6) the degree of the organization's financial autonomy and the source of its operating expenses.

Revenue Ruling 89-49 (1989-1 CB 117), see §601.601(d)(2), provides guidance for determining whether a retirement plan maintained by an organization is a governmental plan within the meaning of section 414(d). The revenue ruling lists several factors for determining whether a sponsoring organization is an agency or instrumentality of the United States or any State or political subdivision thereof. While the factors in Rev. Rul. 89-49 are similar to the factors listed in Rev. Rul. 57-128, Rev. Rul. 89-49 focuses more on the degree of control that the Federal or State government has over the organization's everyday operations. Other factors considered include: whether there is specific legislation creating the organization; the source of funds for the organization; the manner in which the organization's trustees or operating board are selected; and whether the applicable government unit considers the employees of the organization to be employees of the applicable government unit. Rev. Rul. 89-49 provides that satisfaction of one or all of the factors is not necessarily determinative of whether an organization is a governmental entity. See §601.601(d)(2)(ii)(b).

In Rev. Rul. 89-49, citizens of a municipality organized a volunteer fire company. The company was incorporated under its State laws as a nonprofit corporation, and the company was managed under the exclusive control of a board of trustees elected by the volunteer firefighters. Area municipalities, including the municipality that created the

company, entered into contracts with the company to receive fire protection services. Under the contracts, it was agreed that the operations of the volunteer fire company would be under the exclusive control of the board of trustees. While the municipalities made payments for fire protection services to the volunteer fire company pursuant to these contracts, the municipalities did not contribute to the company's retirement plan, and the employees of the company were not considered employees of the State or any of the participating municipalities. The ruling concludes that the retirement plan established and maintained by the volunteer fire company is not a governmental plan within the meaning of section 414(d) because the degree of control that the participating municipalities exert over the volunteer fire company is minimal.

Exclusion of Governmental Plans from ERISA

Section 4(b)(1) of ERISA provides that title I of ERISA does not apply to an employee benefit plan that is a governmental plan as defined in section 3(32) of ERISA. Section 3(32) of ERISA generally provides that the term "governmental plan" means a plan established or maintained for its employees by the Government of the United States, by the government of any State or political subdivision thereof, or by any agency or instrumentality of any of the foregoing.¹⁴ The ERISA section 3(32) definition of a governmental plan also includes any plan to which the Railroad Retirement Act of 1935 or 1937 applies, and which is financed by contributions required under that Act and any plan of an international organization which is exempt from taxation under the provisions of the International Organizations Immunities Act. Section 906 of PPA '06 amended

¹⁴ In defining the term "governmental plan," section 3(32) of ERISA uses the phrase "established or maintained," whereas section 414(d) of the Code and section 4021(b) of ERISA use the term "established and maintained." For further discussion, see the Explanation of Provisions section of the preamble under the heading, "Requirements for establishing and maintaining a section 414(d) governmental plan."

section 3(32) of ERISA to include in the definition of governmental plan a plan which is established and maintained by an Indian tribal government (as defined in section 7701(a)(40)), a subdivision of an Indian tribal government (determined in accordance with section 7871(d)), or an agency or instrumentality of either. Under this definition, all of the participants of which are employees of such entity substantially all of whose services as such an employee are in the performance of essential governmental functions but not in the performance of commercial activities (whether or not an essential government function).

Section 4021(b)(2) of ERISA provides that title IV of ERISA does not apply to any plan established and maintained for its employees by the Government of the United States, by the government of any State or political subdivision thereof, or by any agency or instrumentality of any of the foregoing, or to which the Railroad Retirement Act of 1935 or 1937 applies and which is financed by contributions required under that Act. Similar to section 3(32) of ERISA, section 4021(b) of ERISA was amended by section 906 of PPA '06 to include certain plans of Indian tribal governments in the definition of governmental plan for purposes of section 4021(b) of ERISA.

Neither the DOL nor the PBGC has issued regulations interpreting the terms of sections 3(32) and 4021(b) of ERISA. Both agencies have, however, provided guidance for specific entities in the form of administrative determinations, and advisory opinions or other opinion letters. The IRS, the Department of Labor (DOL), and the Pension Benefit Guaranty Corporation (PBGC) have generally applied a facts and circumstances approach in providing governmental plan determinations.¹⁵ For example,

¹⁵The DOL issues advisory opinions. The PBGC issues administrative determinations and opinion letters. The IRS issues letter rulings relating to section 414(d) governmental plans. For this purpose, a letter

the IRS issues private letter rulings relating to governmental plan status using a facts and circumstances analysis.

Exemption of Governmental Plans from Certain Qualified Plan Rules

Governmental plans under Code section 414(d) are exempt from certain qualification requirements and are deemed to satisfy certain other qualification requirements under certain conditions. For example, the nondiscrimination and minimum participation rules do not apply to governmental plans. Section 1505 of the Taxpayer Relief Act of 1997, Public Law 105-34 (111 Stat. 788, 1063) (TRA '97), amended sections 401(a)(5)(G) and 401(a)(26)(G) of the Code to provide that the minimum participation standards and nondiscrimination requirements of section 410 and the additional participation requirements under section 401(a)(26)(G) do not apply to State or local governmental plans.¹⁶ Section 1505 of TRA '97 also amended section 401(k)(3)(G) of the Code to provide that certain State and local governmental plans are treated as meeting the requirements of the average deferral percentage test of section 401(k)(3) and the average contribution percentage test of section 401(m)(2).¹⁷

Section 861 of PPA '06 exempts all governmental plans (as defined in section 414(d)) from the nondiscrimination and minimum participation requirements of sections 401(a)(5)(G) and 401(a)(26)(G) of the Code, as well as the nondiscrimination and

ruling is a written statement issued to a taxpayer by the IRS that interprets and applies tax laws or any nontax laws applicable to employee benefit plans to the taxpayer's specific set of facts. See section 3.02 of Rev. Proc. 2011-4 (2011-1 IRB 123, 127), see §601.601(d)(2).

¹⁶ In addition, section 1505(a)(3) of TRA '97 amended section 410(c)(2) to provide that all governmental plans within the meaning of section 414(d) are treated as satisfying the nondiscrimination requirements of section 410.

¹⁷ A State or local government, political subdivision, or agency or instrumentality thereof, is not permitted to establish and maintain a section 401(k) plan. See section 401(K)(4)(B)(ii). There is an exception for a grandfathered section 401(k) plan, which is generally a plan established by a governmental unit (a State or local government or political subdivision thereof) before May 7, 1986. See §1.401(k)-1(e)(4).

participation requirements applicable to qualified cash or deferred arrangements under section 401(k)(3)(G) of the Code.

In addition to the nondiscrimination requirements, the Code provides other exemptions for governmental plans:

- Section 401(a)(10)(B)(iii), which provides that the top heavy requirements of section 416 do not apply to a governmental plan.
- Section 410(c)(1)(A), which provides that the minimum participation provisions of section 410 do not apply to a governmental plan.
- Section 411(e), which provides that a governmental plan is treated as satisfying the requirements of section 411 if the plan meets the pre-ERISA vesting requirements.
- Section 412(e)(2)(C), which provides that the minimum funding standards of section 412 do not apply to a governmental plan.
- Section 417, which provides rules relating to qualified joint and survivor annuities and qualified preretirement survivor annuities.

Section 415 also provides a number of special rules for governmental plans. The special rules include section 415(b)(11) (the 100 percent of a participant's average high 3 compensation limitation does not apply), section 415(b)(2)(C) (the reduced limitation to the annual benefit payable beginning before age 62 and the reduction in the dollar limitation to the annual benefit payable for participation or services of less than 10 years do not apply to disability or survivor benefits received from a governmental plan), section 415(m) (benefits provided under a qualified governmental excess benefit arrangement are not taken into account in determining the section 415 benefit

limitations under a section 414(d) governmental plan), and section 415(n) (permissive service credit).¹⁸

As a result, the principal qualification requirements for a tax-qualified governmental plan¹⁹ are the requirements that the plan --

- Be established and maintained by the employer for the exclusive benefit of the employer's employees or their beneficiaries,
- Provide definitely determinable benefits,
- Satisfy the direct rollover rules of sections 401(a)(31) and 402(f),
- Be operated pursuant to its terms,
- Satisfy the section 401(a)(17) limitation on compensation,
- Comply with the statutory minimum required distribution rules under section 401(a)(9),
- Satisfy the pre-ERISA vesting requirements under section 411(e)(2),
- Satisfy the section 415 limitations on benefits, as applicable to governmental plans, and
- Satisfy the prohibited transaction rules in section 503.

State and local governments, political subdivisions thereof, and agencies or instrumentalities thereof are generally not permitted to offer cash or deferred arrangements under section 401(k). Instead, they can offer a somewhat similar elective contribution program through an eligible governmental section 457(b) plan to which

¹⁸ See also Notice 89-23 (1989-1 CB 654), and Notice 96-64 (1996-2 CB 229), see § 601.601(d)(2), for guidance relating to the nondiscrimination rules that apply to qualified plans maintained by governments.

¹⁹ A special rule applies to contributory plans of certain governmental entities. Section 414(h)(2) provides that, for a qualified plan established by a State government or political subdivision thereof, or by any agency or instrumentality of the foregoing, where the contributions of the governmental employer are designated as employee contributions under section 414(h)(1) but the governmental employer picks up the contributions, the contributions picked up will be treated as employer contributions.

section 457(g) applies. In addition, section 403(b) includes special rules for plans covering public school teachers, including rules under which, in conjunction with an eligible governmental section 457(b) plan, the maximum dollar amount of the elective contribution for a public school teacher is in effect double the maximum for other public or private employees.

Exemption of Governmental Plans from Other Employee Benefit Rules Relating to Retirement Plans

The Code and regulations also provide that plans of governmental entities are treated differently than plans of non-governmental entities with respect to certain requirements for section 403(b) plans and eligible section 457(b) plans, including:

- Section 403(b)(1)(A)(ii), which provides that the exclusion allowance under section 403(b)(1) applies to employees who perform services for a public school of a State, a political subdivision of a State, or an agency or instrumentality of any one or more of the foregoing.
- Section 403(b)(12)(C), which provides that the nondiscrimination requirements of section 403(b)(12) (other than the compensation limitations of section 401(a)(17)) do not apply to a State or local governmental plan within the meaning of section 414(d).
- Section 457(f)(2)(E), under which section 457(f) (relating to nonqualified deferred compensation) does not apply to a qualified governmental excess benefit arrangement under section 415(m).
- Section 457(e)(1)(B), which includes as an eligible employer a State, political subdivision, or agency or instrumentality thereof and any tax-exempt organization other than a governmental unit.

- Section 457(g), which provides that a deferred compensation plan maintained by a State, political subdivision of a State, or any agency or instrumentality thereof is not treated as an eligible section 457(b) plan unless the assets and income of the plan are held in trust for the exclusive benefit of plan participants and beneficiaries.
- Section 402(c)(8)(B)(v), which provides that an eligible section 457(b) governmental plan is an eligible retirement plan for purposes of the rollover rules under section 402(c), so that payments from an eligible section 457(b) governmental plan can be rolled over to another eligible retirement plan, such as a qualified plan or an IRA, and payments from an eligible retirement plan can be rolled over into an eligible section 457(b) governmental plan.²⁰ An eligible section 457(b) plan of a nongovernmental tax-exempt entity is not eligible for this rollover treatment.

Legislative History of ERISA

The legislative history of ERISA and its predecessor bills indicate that there were two reasons for the governmental plan exemption: (1) federalism concerns; and (2) the taxing power of State and local governments was thought to offer sufficient protection for participants in public plans.²¹ In a summary of ERISA's predecessor bill, Senator

²⁰ Section 402(c)(8)(B) defines an eligible retirement plan as an individual retirement account under section 408(a), an individual retirement annuity under section 408(b), a qualified plan, a section 403(a) annuity, a section 403(b) plan, and an eligible section 457(b) governmental plan.

²¹ ERISA included a directive for the Committee on Education and Labor and the Committee on Ways and Means of the House of Representatives and the Committees on Finance and on Labor and Public Welfare of the Senate to study pension retirement plans sponsored by Federal, State, and local governments and analyze: (1) the adequacy of existing levels of participation, vesting and financing arrangements; (2) existing fiduciary standards; and (3) the necessity for Federal legislation and standards

Lloyd Bentsen commented that “State and local governments must be allowed to make their own determination of the best method to protect the pension rights of municipal and state employees. These are questions of state and local sovereignty and the Federal Government should not interfere.”²²

While Congress was concerned about pension protection for public as well as private employees, governmental plans have been excluded from many of the qualification requirements because, in addition to federalism concerns, Congress believed that “the ability of governmental bodies to fulfill their obligations to employees through their taxing powers is an adequate substitute for termination insurance.”²³ As a result, ERISA includes exclusions for governmental plans under titles I and IV of ERISA and an exemption for governmental plans from most of the qualification requirements under the Code that were added under title II of ERISA (as described in this preamble under the heading, “Exemption of Governmental Plans from Certain Qualified Plan Rules”).

Interagency Coordination on Governmental Plan Determinations

Historically, the IRS, DOL, and PBGC (the Agencies) have informally conferred prior to making determinations on governmental plan status in individual cases. In Notice 2005-58 (2005-2 CB 295), see §601.601(d)(2), the Treasury Department and the IRS stated their intention of publishing guidance regarding governmental plans under section 414(d). The Agencies have become increasingly concerned with the growing number of requests for governmental plan determinations from plan sponsors whose

with respect to such plans. See Staff of House Comm. On Education and Labor, 95th Cong., 2d Sess., *Pension Task Force Report on Public Employee Retirement Systems* (Comm. Print 1978).

²² Staff of the Senate Comm. on Labor and Public Welfare, 94th Cong., *Legislative History of the Employee Retirement Income Security Act of 1974*, Vol. I 220 (Comm. Print 1976).

²³ S. Rep. No. 93-383, at 81 (1973). See also H.R. Rep. No. 93-807, at 164-5 (1974).

relationships to States or political subdivisions thereof are increasingly remote and whose arguments for concluding that their plans are governmental plans raise novel issues. The use of differing approaches by the courts and the Agencies has resulted in uncertainty as entities with organizational, regulatory, and contractual connections with States or political subdivisions of States try to ascertain which statutory and regulatory requirements apply to their retirement plans. These proposed regulations are intended to address this issue by establishing coordinated criteria for determining whether a plan is a governmental plan within the meaning of section 414(d) of the Code. Although these proposed regulations are only applicable for purposes of section 414(d), the DOL and the PBGC were consulted in developing this proposal. The DOL and the PBGC agreed that it would be advantageous for the Agencies and other affected parties to have coordinated criteria for determining whether a plan is a governmental plan within the meaning of section 414(d) of the Code, section 3(32) of title I of ERISA, and section 4021(b) of title IV of ERISA. In that regard, comments are requested on any issues arising from these proposed regulations in light of the interaction of the governmental plan definition in the Code with the governmental plan definitions in section 3(32) of title I of ERISA and section 4021(b) of title IV of ERISA. Copies of the comments on these regulations will be forwarded to the DOL and the PBGC.

Explanation of Provisions

I. Overview

A. In general.

These proposed regulations would generally define the term “governmental plan” within the meaning of section 414(d) of the Code. These proposed regulations would

also define other key terms relating to the general definition of “governmental plan,” including the definitions of “State,” “political subdivision of a State,” and “agency or instrumentality of a State or political subdivision of a State.” While these terms are commonly used in other Code sections, the definitions in these proposed regulations are only applicable for purposes of section 414(d), and not for any other purpose under the Code. For example, the definition of the term “instrumentality” under these proposed regulations may be different for other purposes under the Code.

As stated, the regulations under section 414(d) would only define the term “agency or instrumentality of the United States” and “agency or instrumentality of a State or political subdivision of a State” for purposes of determining whether a plan is a governmental plan under section 414(d). Thus, the rules in these proposed regulations would not apply for purposes of defining the term “instrumentality,” under any other provisions of the Code.

In addition, these regulations do not address certain issues relating to governmental entities, including when an entity is so closely related to a State that it constitutes an “integral part” of a State.²⁴ The criteria for treating an entity as an “integral part” of a State will be the subject of a separate guidance project. Such guidance defining “integral part” may include stricter criteria than would apply under these proposed regulations for determining whether an entity is an agency or instrumentality of a State.

B. Definition of governmental plan.

²⁴ Over the years, the IRS has extended the income tax exemption it provides to states and political subdivisions to entities it regards as their “integral parts.” See Rev. Rul. 87-2, 1987-1 C.B. 18; see also Treas. Reg. § 301.7701-1(a)(3).

These proposed regulations reflect the statutory definition of the term “governmental plan” as a plan established and maintained for its employees by the Government of the United States, by the government of any State or political subdivision thereof, or by any agency or instrumentality of the foregoing. Within this definition, there are several key terms relating to governmental plans, the definitions of which are set forth in these proposed regulations. As mentioned in the “Background” section of this preamble, section 414(d) also includes special rules relating to the Railroad Retirement Act of 1935 or 1937, the International Organizations Immunities Act, and plans of Indian tribal governments. These proposed regulations do not address the term “governmental plan” as it relates to the special provisions in section 414(d) relating to the Railroad Retirement Act of 1935 or 1937, or the International Organizations Immunities Act. The special rules for Indian tribal governments are reserved in these proposed regulations and are in a separate notice of proposed rulemaking, which is being published elsewhere in the Rules and Regulations portion of this issue in the **Federal Register**.

C. Definitions of the United States and agency or instrumentality of the United States.

These proposed regulations would define the term “United States,” for purposes of the governmental plan definition under section 414(d), as having the same meaning set forth in section 7701(a)(9). Section 7701(a)(9) provides that the term “United States,” when used in a geographical sense, includes only the States and the District of Columbia.

Whether an entity is an “agency or instrumentality of the United States” is determined based on the specific purpose for which the designation is sought and is

decided by determining if Congress intended the entity to be treated as a Federal entity for the specific purpose.²⁵ The proposed regulations would define the term “agency or instrumentality of the United States” as an entity that satisfies the facts and circumstances test as set forth in these regulations. The facts and circumstances test, similar to the factors weighed by the Berini court, focuses on the “degree to which the entity is connected with the . . . federal government.”²⁶ The factors in this test are a compilation of various different tests used for governmental plan determinations, including factors in the Berini and Rose cases, as well as Rev. Ruls. 57-128 and 89-49. The facts and circumstances test is similar to that proposed for agencies and instrumentalities of a State or political subdivision thereof, (which is described in this preamble under the heading, “Definition of agency or instrumentality of a State or political subdivision of a State”) but modified to reflect that this definition does not implicate the federalism concerns present in making determinations relating to agencies and instrumentalities of a State or political subdivision thereof.

The proposed regulations provide that, in making a determination of whether an entity is an “agency or instrumentality of the United States,” the factors to be considered include whether:

- The entity performs or assists in the performance of a governmental function.
- There are no private interests involved, or the Government of the United States has all of the powers and interests of an owner. In determining whether an entity that holds stock has a private interest, stock will not be considered a private

²⁵ See Berini v. Federal Reserve Bank of St. Louis, 420 F.Supp.2d at 1025.

²⁶ Id.

interest if the stock of the corporation is not acquired for investment purposes or for purposes of control.²⁷

- The control and supervision of the entity is vested in the Government of the United States. Control must be more than the government's extensive Federal regulation of an industry.
- The entity is exempt from Federal, State, and local tax by an Act of Congress.
- The entity is created by the United States Government pursuant to a specific enabling statute that prescribes the purposes, powers, and manner in which the entity is to be established and operated.
- The entity receives financial assistance from the Government of the United States. However, an entity is not a governmental entity merely because it receives funds from the Government of the United States under a contract to provide a governmental service.
- The entity is determined to be an agency or instrumentality of the United States by a Federal court.
- Other governmental entities recognize and rely on the entity as an arm of the Government of the United States.
- The entity's employees are treated in the same manner as Federal employees for purposes other than providing employee benefits (for example, the entity's employees are granted civil service protection).

²⁷ The Department of Treasury and the IRS recognize that an entity may hold stock for purposes other than investment and control. For example, the federal reserve banks are required to hold stock in the Federal Reserve Bank of its district because ownership is a condition of being a member in the Federal Reserve System. Unlike stock in a private corporation, this stock is not acquired for investment purposes or for purposes of control. See Berini v. Federal Reserve Bank of St. Louis, 420 F. Supp.2 at 1024, citing Lee Const. Co., Inc. v. Federal Reserve Bank of Richmond, 558 F.Supp. 165, 177 n.17 (D.Mich. 1982), citing 4 F. Solomon, W. Schlichting, T. Rice & J. Cooper, Banking Law, § 77.02, at 77-6 to 77-7 (1982).

These proposed regulations also provide an example, illustrating the application of the facts and circumstances test to a particular entity -- a Federal credit union. As announced in previous guidance, one purpose of these regulations is to address whether a Federal credit union is a governmental entity for purposes of determining whether the Federal credit union can maintain an eligible nonqualified deferred compensation plan. Notice 2005-58 addresses certain income tax issues with respect to nonqualified deferred compensation plans maintained by Federal credit unions, including whether a Federal credit union can maintain an eligible nonqualified deferred compensation plan described in section 457(b). Under Notice 2005-58, a plan in effect on August 15, 2005, that is maintained by a Federal credit union and that is intended to be an eligible nonqualified deferred compensation plan of a non-governmental tax-exempt employer would not fail to be an eligible plan under section 457(b) solely because the employer is a Federal credit union, provided that certain conditions are satisfied (including the condition that the plan of the Federal credit union not have claimed to be a governmental plan for purposes of section 414(d) of the Code and section 3(32) of ERISA). The rule in Notice 2005-58 only applies pending the issuance of future guidance regarding section 414(d). See §601.601(d)(2)(ii)(b). Accordingly, upon adoption of these regulations as final regulations, the special treatment provided in Notice 2005-58 for Federal credit unions will no longer apply. However, after issuance of these regulations as final regulations, a Federal credit union can be an eligible employer within the meaning of section 457(e)(1)(B) on the basis that Federal credit unions are non-governmental tax-exempt organizations.

D. Definitions of State and political subdivision of a State.

The proposed regulations define the term “State” as any State of the United States and the District of Columbia. This definition, which is based on the definition of “State” in section 7701(a)(10), is different from the definition of “State” under section 3(10) of ERISA, which defines, in relevant part, the term “State” as any State of the United States, the District of Columbia, Puerto Rico, the Virgin Islands, America Samoa, Guam, and Wake Island.

The term “political subdivision of a State” is defined in these proposed regulations as a regional, territorial, or local authority, such as a county or municipality (including a municipal corporation), that is created or recognized by State statute to exercise sovereign powers.²⁸ Examples of sovereign powers include the power of taxation, the power of eminent domain, and the police power. The definition of “political subdivision of a State” also provides that the governing officers of the authority must be appointed by State officials or publicly elected.

The term “political subdivision of a State” has been used for purposes other than section 414(d), including the NLRA and section 103.²⁹ The definition in these proposed regulations of the term “political subdivision of a State” applies only for purposes of section 414(d), and not for any other purposes under the Code or any other statute, including whether an entity is treated as a political subdivision for purposes of the NLRA or section 103 of the Code.

²⁸ For certain purposes, the effect of an entity being determined to be a political subdivision of a State may be similar to the entity being determined to be an agency or instrumentality of a State or political subdivision and for other purposes the effects may be different. Examples in which it is relevant whether an entity is a political subdivision in contrast to an agency or instrumentality of a State or political subdivision include the exclusion provided under section 402(l), the excise tax under section 4965, and the exception to the 10 percent additional tax under section 72(t)(10).

²⁹ Two court cases that have analyzed whether an entity is a “political subdivision of a State” for purposes of section 103 of the Code are Commissioner of Internal Revenue v. Shamberg’s Estate, 144 F.2d 998 (2nd Cir. 1944), cert. denied, 323 U.S. 792 (1945), and Commissioner of Internal Revenue v. White’s Estate, 144 F.2d 1019 (2nd Cir. 1944), cert. denied, 323 U.S. 792 (1945).

E. Definition of agency or instrumentality of a State or a political subdivision of a State.

These proposed regulations would provide guidance on determining whether an entity is an “agency or instrumentality of a State or a political subdivision of a State.”

These regulations would provide that the determination is based on a facts and circumstances test. The proposed regulations provide that numerous factors have been applied by the IRS in determining whether an entity is an agency or instrumentality of a State or a political subdivision of a State. Satisfaction of one or more of the factors is not necessarily determinative of whether an organization is a governmental entity. One factor that is not weighed by the IRS is the way the entity refers to itself. For example, the mere fact that an entity is called the “Educational Service Agency of City A” would not be a factor in determining whether the entity is an agency or instrumentality of City A.

Major factors for determining whether an entity is an agency or instrumentality of a State or political subdivision of a State are whether:

- The entity’s governing board or body is controlled by a State or political subdivision.
- The members of the governing board or body are publicly nominated and elected.
- The entity’s employees are treated in the same manner as employees of the State (or political subdivision thereof) for purposes other than providing employee benefits (for example, the entity’s employees are granted civil service protection).

- A State (or political subdivision thereof) has fiscal responsibility for the general debts and other liabilities of the entity (including funding responsibility for the employee benefits under the entity's plans).
- In the case of an entity that is not a political subdivision, the entity is delegated, pursuant to a statute of a State or political subdivision, the authority to exercise sovereign powers of the State or political subdivision (such as, the power of taxation, the power of eminent domain, and the police power).

It is expected that, in applying the factor relating to whether the entity's governing board or body is controlled by a State or political subdivision, the control cannot be a mere legal possibility. Examples of situations in which the control factor might be a mere legal possibility are cases in which there are a number of tiers of intervening corporations between the entity and the State, and cases in which the legal power to control is shared among so many governing entities that none of them can be said to be responsible in the event of a failure to exercise control. In addition, since these two factors are interrelated, an entity that would satisfy the control factor would not be expected to satisfy the factor relating to whether members of the governing board or body are publicly elected or nominated. Alternatively, an entity that would satisfy the factor relating to whether members of the governing board or body are publicly elected or nominated would not be expected to satisfy the control factor.

Other factors for determining whether an entity is an agency or instrumentality of a State or political subdivision of a State are whether:

- The entity is created by a State government or political subdivision pursuant to a specific enabling statute that prescribes the purposes and powers of the entity, and the manner in which the entity is to be established and operated.
- The entity is directly funded through tax revenues or other public sources.
- The entity is treated as a governmental entity for Federal employment tax or income tax purposes (for example, whether the entity has the authority to issue tax-exempt bonds under section 103(a) of the Code) or under other Federal laws.
- The entity's operations are controlled by a State or political subdivision.
- The entity is determined to be an agency or instrumentality of a State or political subdivision thereof for purposes of State law. For example, the entity is subject to open meetings laws or the requirement to maintain public records that apply only to governmental entities, or the State attorney general represents the entity in court under a State statute that only permits representation of State entities.
- The entity is determined to be an agency or instrumentality of a State or political subdivision thereof by a State or Federal court for purposes other than section 414(d).

There are two additional factors to be considered. First, if a party other than a State (or political subdivision, agency, or instrumentality thereof) has an ownership interest, or other similar interests, in the entity, this factor would indicate that the entity is not an agency or instrumentality of a State or political subdivision thereof (however, an entity would not necessarily be considered an agency or instrumentality of a State or political subdivision thereof merely because there is no private ownership in the entity or the entity serves a governmental purpose). Second, if an entity does not serve a

governmental purpose, this factor would indicate that it is not an agency or instrumentality of a State (or political subdivision thereof).

The proposed regulations include a variety of examples to illustrate whether an entity is an agency or instrumentality of a State or political subdivision thereof. Many of these examples are drawn from prior judicial opinions, as well as the Agencies' determinations.³⁰ Within the description of particular factors, there are some examples that illustrate whether a particular factor is satisfied. However, the mere satisfaction of a particular factor is not conclusive in determining whether an entity is an agency or instrumentality within the meaning of these regulations.

F. Requirements for establishing and maintaining a section 414(d) governmental plan.

The proposed regulations would provide that a plan is established and maintained for the employees of a governmental entity if the following requirements are satisfied: (1) the plan is established and maintained by an employer within the meaning of §1.401-1(a)(2) of the Income Tax Regulations;³¹ (2) the employer is a governmental entity; and (3) the only participants covered by the plan are employees of the governmental entity. For purposes of determining whether employees covered by a plan are employees of a governmental entity, employee representatives described in section 413(b)(8) (including individuals who are employed by the plan) would be treated as employees of the plan sponsor.³²

³⁰ See, for example, Brock v. Chicago Zoological Society, 820 F.2d 909 (7th Cir. 1987) and NLRB v. Parents & Friends of the Specialized Living Center, 879 F.2d 1442 (7th Cir. 1989).

³¹ Section 1.401-1(a)(2) generally provides that a qualified pension, profit-sharing, or stock bonus plan is a definite written program and arrangement which is communicated to the employees and which is established and maintained by an employer.

³² See §1.413-1(i)(1) for rules for when an employee is an employee representative.

The proposed regulations would provide rules for changes in status of an entity from a private entity to a governmental entity and from a governmental entity to a private entity. As mentioned in the “Background” section of this preamble, the qualification requirements for a private qualified plan differ substantially from those of a governmental qualified plan. The issue of whether a plan of a private employer that later becomes a governmental entity can be a governmental plan raises a question regarding the interaction among the three definitions of the term “governmental plan” in ERISA. Section 414(d) of the Code defines the term “governmental plan” as “a plan established and maintained by the Government of the United States, by the government of any State or political subdivision thereof, or by any agency or instrumentality of the foregoing.” In title IV of ERISA, section 4021(b)(2) provides that any plan “established and maintained for its employees by the Government of the United States, by the government of any State or political subdivision thereof, or by any agency or instrumentality of the foregoing” is exempt from coverage by ERISA. In title I of ERISA, section 3(32) defines a governmental plan as “a plan established or maintained by the Government of the United States, by the government of any State or political subdivision thereof, or by any agency or instrumentality of the foregoing.” While the definitions in title II of ERISA (Code) and title IV of ERISA (PBGC provisions) use the language “established *and* maintained” by a governmental employer, the title I definition uses the language “established *or* maintained.”

This difference in statutory language was addressed in Rose v. Long Island Railroad Pension Plan, 828 F.2d 910 (2nd Cir. 1987), cert. denied, 485 U.S. 936 (1988). In Rose, the State of New York, through the Metropolitan Transportation Authority

(MTA), acquired the Long Island Railroad Company in 1966 (LIRR). The LIRR had originally been chartered as a private stock corporation. As part of the acquisition, the State also assumed sponsorship of the Long Island Railroad Pension Plan (LIRR Pension Plan). After ERISA was enacted in 1974, the widow of a participant who died in 1976 in the LIRR Pension Plan sued the plan under title I of ERISA after being denied survivorship benefits. The Rose court concluded that the LIRR Pension Plan was a governmental plan within the meaning of section 3(32) of ERISA because the LIRR was an agency or instrumentality of a political subdivision, the MTA.

The Rose court took the position that if a private entity is acquired by a governmental entity which becomes the plan sponsor, the plan can be established by the governmental entity and, thus, be a governmental plan. The court interpreted the “established or maintained” language in section 3(32) literally, but also noted the discrepancy between the “established or maintained” language in ERISA section 3(32) and the “established and maintained” language in Code section 414(d) and ERISA section 4021(b)(2) (emphasis added). Despite this difference in the three statutory definitions, Congress intended all three definitions to be interpreted in a similar manner. The Rose court reasoned that:

“If a plan is required to have been both established and maintained by a governmental entity in order to qualify for exemption, then a plan which was established by a private entity but subsequently taken over by a governmental body would continue to be subject to ERISA. This outcome conflicts with the federalism-based concerns which led Congress to exempt governmental plans in the first place.” Rose v. Long Island Railroad Pension Plan, 828 F.2d at 920.

The Rose court stated that courts have interpreted the word “and” as meaning “or” if such interpretation would reflect the legislative intent of the statute.³³ The Rose

³³ See Rose v. Long Island Railroad Pension Plan, 828 F.2d at 919.

court noted that its conclusion was consistent with the approach taken by the PBGC in a similar matter involving an entity's change to governmental status prior to the enactment of ERISA where the PBGC stated that it would not impose the "established" requirement when doing so would frustrate the congressional intent of section 4021(b)(2) of ERISA.³⁴

The Rose court also noted that the LIRR Pension Plan had been rewritten and substantially funded by the State since its acquisition of the LIRR in 1966, and stated that it would have reached the same conclusion regarding the plan's governmental status even if the definition under section 3(32) of ERISA used the phrase "established and maintained."

"In any event, even if we agreed with Rose that the correct interpretation of [section 3(32) of ERISA] was established and maintained, we would still not conclude that the LIRR Plan was covered by ERISA, because the Plan was in fact established and maintained by the LIRR."

Rose v. Long Island Railroad Pension Plan, 828 F.2d at 920. See also Roy v. Teachers Insurance and Annuity Association, 878 F.2d 47 (2nd Cir. 1989).

The court concluded that a broad reading of the term "established"--whereby a plan not previously established under ERISA may become a plan established under ERISA without the preexisting one having been formally "terminated"--is more consistent with the legislative intent behind the governmental plan exemption.³⁵

³⁴ The Rose court said that: "We find the PBGC's approach to be a sensible one; the status of the entity which currently maintains a particular pension plan bears more relation to Congress' goals in enacting ERISA and its various exemptions, than does the status of the entity which established the plan." Rose v. Long Island Railroad Pension Plan, 828 F.2d at 920. See PBGC Opinion Letter 75-44 (December 9, 1975).

³⁵ But see Hightower v. Texas Hospital Association, 65 F.3d 443, 448 (5th Cir. 1995), in which the Fifth Circuit held that if the plan was "established or maintained" for its employees by a governmental employer, the plan was exempt from coverage under title I of ERISA, even if it was not exempt from coverage under the title IV "established and maintained" test. The Court of Appeals held that the difference in statutory language between "established or maintained" and "established and

For reasons similar to those presented by the Rose court, but consistent with the “established and maintained” language in section 414(d), the proposed regulations would set forth rules for employers changing status from private to governmental that are consistent with the legislative intent of the exemption of governmental plans. The proposed regulations would provide that if an employer becomes a governmental entity or a governmental entity becomes the employer under the plan (for example, in connection with an asset transfer), the plan will be treated as a governmental plan established by a governmental employer on the date of the change (including all of the plan’s assets and liabilities attributable to service before and after the date of the change). Thus, in such a case, under the proposed regulations, the plan would have to comply with all the requirements for a private plan up to the date of the change and then comply with the requirements for a governmental plan after the date of the change. These same rules would also apply if a portion of a private plan was spun off to a plan maintained by a governmental employer: that portion of the plan would cease to be subject to Code rules applicable to nongovernmental employers, and instead would become part of a governmental plan, while the remaining portion of the private plan that was not spun off would continue to be subject to the protection and other rules applicable to private plans. These rules would provide standards for determining when the Code protections and other rules for a private plan cease to apply (and when the substantially different rules for a governmental plan begin to apply).

maintained” had to be given some meaning, and held that for a plan to be a governmental plan under ERISA section 4021(b)(2), the plan had to be both established and maintained by the government. Id. at 450-51. The court did not discuss what, if any, actions would be sufficient for an employer assuming sponsorship of an existing plan to be treated as having “established” the plan.

In the case of a change in status from a private plan to a governmental plan, comments are requested on whether, and if so how, these regulations should address rights and obligations that accrued prior to the conversion to a governmental plan, including the responsibility of the former private plan sponsor (or former private plan) for benefits that accrued prior to the conversion. Any comments that address the potential impact of the proposed regulation's approach on rights and responsibilities under title I and title IV of ERISA will be forwarded to the DOL and the PBGC.

Similarly, the regulations would provide that if a governmental employer ceases to be a governmental entity, the plan will be treated as being established by a private employer thereafter (including all of the plan's assets and liabilities attributable to service before and after the date of the change). Such a change would occur either where the employer entity ceases to be a governmental entity (such as a spin-off of a corporation) or where the employees become employees of a different entity (such as in an asset transfer). Thus, for example, the entity in either case would no longer satisfy the requirement that the employer be a governmental entity. If such a change occurs, the plan must comply with the requirements for a governmental plan up to the change and then comply with all the requirements for a private plan for periods after the date of the change. (See also the related discussion under the heading, "Comments and Public Hearing.")

In the case of a formerly governmental plan becoming a private plan, the plan and plan sponsor may secure certain advantages, such as PBGC coverage or ERISA preemption, not available to governmental plans and governmental sponsors. However, nothing in these proposed income tax regulations should be construed to mean that,

with respect to a transaction such as an asset sale, in which assets and liabilities of a governmental plan are transferred to a private plan, the assumption of benefit liabilities accrued prior to the transfer to the private plan relieves the former governmental employer (or former governmental plan) from responsibility for those benefits.

As previously stated, the proposed regulations would provide that if a governmental employer ceases to be a governmental entity, the plan will be treated as being established by a private employer on the date of the change. The proposed regulations would provide an exception to this general rule when there is a change in status from a governmental entity to a private entity under certain circumstances. Specifically, if a governmental plan ceases to be maintained by a governmental employer, the plan will nevertheless be treated as continuing to be a governmental plan if the benefits held under the governmental plan are frozen and a governmental entity assumes responsibility for the plan. While the frozen plan would continue to be treated as a governmental plan, the plan would be permitted (but not required) to provide participating employees with credit for service with the new employer for purposes of vesting, final pay adjustments, entitlements to benefits such as early retirement benefits, and similar service credit other than benefit accrual credit.

Further, certain types of plans are limited under the Code to specific types of employers, including limitations that apply differently depending on whether or not the employer is or is not a governmental entity. These limitations on employer eligibility raise special problems for cases in which an entity becomes or ceases to be a governmental employer. For example, because a qualified cash or deferred arrangement under section 401(k) generally cannot be maintained by a State or local

government or political subdivision, or any agency or instrumentality thereof, such a plan maintained by a private employer cannot be continued if the employer later becomes part of a State. Other special problems arise if a governmental employer that is not a tax-exempt organization under section 501(c)(3) and that is not a public school attempts to become a sponsoring employer of a section 403(b) plan of a tax-exempt organization under section 501(c)(3). Likewise, a State entity cannot maintain an unfunded section 457(b) plan of a tax-exempt organization described in section 457(e)(1)(B). These proposed regulations would not alter rules relating to the eligibility of an employer to establish or maintain a particular type of retirement plan. An employer that is considering a change in its status should evaluate whether it is eligible to sponsor any plan that it assumes, taking into account the employer eligibility rules. Therefore, sponsors should not assume from these proposed regulations that a change of sponsorship from a private to governmental employer, or vice versa, will not result in any adverse tax consequences. As emphasized elsewhere in this preamble, the proposed regulations would provide that the established and maintained rules apply only for purposes of section 414(d).

Proposed Effective Date

It is expected that these proposed regulations would not be applicable earlier than for plan years beginning after the date of the publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**. Generally, amendment of a State or local retirement plan requires enactment of State legislation. The Department of Treasury and IRS intends to take into consideration the time

required to complete the State legislative process when determining an effective date for these regulations.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. In addition, because no collection of information is imposed on small entities, the provisions of the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply, and therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The Treasury Department and the IRS specifically request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying.

These proposed regulations would provide that a determination of whether an entity is an agency or instrumentality of a State or a political subdivision thereof is based on a facts and circumstances analysis. Under the proposed regulations, the factors to

be applied would be ranked into main factors and other factors.³⁶ Comments are requested on whether the final regulations should eliminate the distinction between main and other factors. Comments are also requested on the ordering and the application of the main and other factors; for example, whether the final regulations should provide a list of factors with a safe harbor standard under which, if an entity satisfies identified factors, the entity will be treated as an agency or instrumentality of a State or political subdivision thereof, for purposes of section 414(d). Comments are also requested on whether the distinction between main and other factors should be retained, in addition to providing a safe harbor standard.

The factors identified in this bright line test might be whether: (1) a majority of the entity's governing board or body are either controlled by a State or political subdivision thereof or elected through periodic, publicly held elections (with the nominees elected by the voters); and (2) a State or political subdivision thereof has the fiscal responsibility for the general debts and other liabilities of the entity, including the entity's employee benefit plans. This standard might be available only if the entity was created by a State government or political subdivision pursuant to a specific enabling statute that prescribes the purposes, powers, and manner in which the entity is to be established and operated.

Apart from the special rules relating to plan coverage for employees of a labor union or plan under section 413(b)(8), these proposed regulations do not include special rules addressing existing practices under which a small number of private employees participate in a plan that would otherwise constitute a governmental plan under section

³⁶ For a list of the factors, see discussion under the heading Definition of Agency or Instrumentality of a State or a Political Subdivision of a State in the Explanation of Provisions of this preamble.

414(d). Comments are requested on whether an exception should be provided in such cases. Parameters that could be taken into account for such a special rule include the following: (1) whether the private employees were previously employees of the sponsoring governmental entity; (2) whether the private employees were previously participants in the governmental plan; (3) whether the number or percentage of such former employees who participate in the governmental plan is de minimis (and, if so, what constitutes a de minimis number or percentage); (4) whether the coverage is pursuant to pre-existing plan provisions; (5) whether the private employer performs a governmental function and has been officially designated as a State entity for plan participation purposes; and (6) whether the employer is ineligible to sponsor the particular type of governmental plan (for example, whether a private employer is a tax-exempt organization under section 501(c)(3) that can sponsor a section 403(b) plan, and whether the private employer sponsors or has sponsored plans that cannot be sponsored by a State governmental entity, such as a cash or deferred arrangement under section 401(k) or an unfunded section 457(b) plan of a tax-exempt entity (described in section 457(e)(1)(B)).

If any special rule for such circumstances were to be included in the final regulation, there would be a number of related issues. These issues would include how to address the status of such a plan as a governmental multiple employer plan. Other issues might include how section 414(h) governmental pick-up plans should be treated, differences resulting from the application of federal employment taxes to a private employer participating in a governmental multiple employer plan, the application of the minimum funding rules with respect to a private employer participating in a

governmental multiple employer plan, how the prohibited transaction rules of section 4975 would apply with respect to a private employer participating in a governmental multiple employer plan, how the special benefit limitation rules of section 415 would apply to private plan participants in the governmental plan; and what treatment should apply where the plan was previously a funded section 457(b) plan of a State or local government.

If the final regulations do not provide any special rule for cases in which a governmental plan continues to cover private employees who were formerly governmental employees, it is expected that a reasonable transition period following publication of the final regulations will be provided. Comments are requested on what transitional relief should be provided to a governmental plan that covers private employees who were formerly governmental employees and continue to participate in the plan that would otherwise constitute a governmental plan under section 414(d) (such as the governmental plan spinning off a portion of the assets and liabilities of the plan with respect to the former employees as a separate non-governmental plan). Comments are also requested on whether this method of correction might also be appropriate in situations such as described in Example 5 in paragraph (k)(4) of the proposed regulations.

The final regulations may also provide transitional relief for entities that previously operated as if they were governmental entities eligible to participate or sponsor governmental plans but later were determined to be private entities under the regulations. Comments are requested on what transitional relief should be provided to an entity that is later determined to be a private entity. The Treasury Department and

the IRS anticipate that there will be a reasonable transition period following the final regulations for a plan to revise its arrangements in order to avoid the adverse tax consequences of failing to comply with all the requirements of a private retirement plan.

A public hearing has been scheduled for (date to be provided when proposed regulations are published), beginning at 10 a.m. in the Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington DC. Due to building security procedures, visitors must enter at the main entrance located at 1111 Constitution Avenue, NW. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the “FOR FURTHER INFORMATION CONTACT” portion of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments must submit written or electronic comments and an outline of the topics to be discussed and time to be devoted to each topic (signed original and eight (8) copies) by (date to be provided when proposed regulations are published). A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving comments has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these proposed regulations is Pamela R. Kinard, Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities),

Internal Revenue Service. However, personnel from other offices of the IRS and Treasury participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par.2. Section 1.414(d)-1 is added to read as follows:

§1.414(d)-1 Definition of governmental plan.

(a) Definition of governmental plan--(1) In general. In accordance with section 414(d), for purposes of part I of subchapter D of chapter 1 of the Internal Revenue Code and the regulations, the term governmental plan means a plan established and maintained for its employees by the Government of the United States, by the government of any State or political subdivision thereof, or by any agency or instrumentality of the foregoing, as determined pursuant to the requirements of this section. The definitions set forth in this section only apply for purposes of section 414(d) and this section.

(2) Definition for plans subject to certain statutes. For purposes of part I of subchapter D of chapter 1 of the Internal Revenue Code and the regulations, the term “governmental plan” also includes any plan to which the Railroad Retirement Act of 1935 or 1937 applies and which is financed by contributions required under that Act and

any plan of an international organization which is exempt from taxation by reason of the International Organizations Immunities Act (59 Stat. 669).

(3) Definition for certain plans of Indian tribal governments. For purposes of part I of subchapter D of chapter 1 of the Internal Revenue Code and the regulations, the term “governmental plan” also includes a plan which is established and maintained by an Indian tribal government (as defined in section 7701(a)(40)), a subdivision of an Indian tribal government (determined in accordance with section 7871(d)), or an agency or instrumentality of either, and all of the participants of which are employees of such entity substantially all of whose services as such an employee are in the performance of essential governmental functions but not in the performance of commercial activities (whether or not an essential governmental function).

(b) Definition of United States. The term United States has the meaning set forth in section 7701(a)(9).

(c) Definition of agency or instrumentality of the United States--(1) Agency or instrumentality of the United States. For purposes of the definition of “governmental plan” in paragraph (a)(3) of this section, the term agency or instrumentality of the United States means an entity that satisfies the facts and circumstances test in paragraph (c)(2) of this section.

(2) Facts and circumstances test. Whether an entity is an agency or instrumentality of the United States is based on facts and circumstances. In making this determination, the facts to be considered include the following:

(i) The entity performs or assists in the performance of a governmental function.

(ii) There are no private interests involved, or the Government of the United States has all of the powers and interests of an owner. In determining whether an entity that holds stock has a private interest, stock will not be considered a private interest if the stock of the corporation is not acquired for investment purposes or for purposes of control.

(iii) The control and supervision of the entity is vested in the Government of the United States. Control must be more than the government's extensive Federal regulation of an industry.

(iv) The entity is exempt from Federal, State, and Local tax by an Act of Congress.

(v) The entity is created by the United States Government pursuant to a specific enabling statute that prescribes the purposes, powers, and manner in which the entity is to be established and operated.

(vi) The entity receives financial assistance from the Government of the United States. However, an entity is not a governmental entity merely because it receives funds from the Government of the United States under a contract to provide a governmental service.

(vii) The entity is determined to be an agency or instrumentality of the United States by a Federal court.

(viii) Other governmental entities recognize and rely on the entity as an arm of the Government of the United States.

(ix) The entity's employees are treated in the same manner as Federal employees for purposes other than providing employee benefits (for example, the entity's employees are granted civil service protection).

(3) Example. The following example illustrates the application of this paragraph (c):

Example. (i) Facts. Entity A is a Federal credit union, which is created pursuant to the Federal Credit Union Act, and is a tax-exempt organization under section 501(c)(1)(A)(i). Membership in the Federal credit union is not open to the general public but to individuals who share a common bond, current or former employees of specified employers. Entity A is member-owned and is controlled by a board of directors that is elected by its membership. Entity A, along with other Federal credit unions, is subject to regulation by the National Credit Union Administration (NCUA), which is a Federal agency that charters and regulates Federal credit unions.

(ii) Conclusion. Based on the facts and circumstances and the factors in paragraph (c)(2) of this section, Entity A is not an agency or instrumentality of the United States because its board of directors is elected by its own members and the directors are not responsible to the United States, except to the limited extent set forth in the Federal Credit Union Act and regulated by the NCUA. Thus, Entity A is not a governmental entity within the meaning of paragraph (c) of this section.

(d) Definition of State. The term State means any State of the United States and the District of Columbia.

(e) Definition of political subdivision of a State. The term political subdivision of a State means--

(1) A regional, territorial, or local authority, such as a county or municipality (such as, a municipal corporation), that is created or recognized by State statute to exercise sovereign powers (which generally means the power of taxation, the power of eminent domain, and the police power); and

(2) The governing officers either are appointed by State officials or publicly elected.

(f) Definition of agency or instrumentality of a State or political subdivision of a State--(1) Agency or instrumentality of a State or political subdivision of a State. The term agency or instrumentality of a State or political subdivision of a State means an entity that satisfies the facts and circumstances test in paragraph (f)(2) of this section.

(2) Facts and circumstances test--(i) Factors to be considered. In making the determination of whether an entity is an agency or instrumentality of a State or political subdivision of a State, the main factors to be considered are--

(A) The entity's governing board or body is controlled by a State (or political subdivision thereof). For example, an entity's governing board or body is controlled by a State (or political subdivision thereof) if the public officials of the State (or political subdivision thereof) have the power to appoint, and to remove and replace, a majority of the entity's governing board or body. This factor is not satisfied if the power to control is materially restricted (for example, if any board member of the entity can be replaced only with an individual chosen from a list of designees selected by the other members of the governing board or body);

(B) The members of the governing board or body are publicly nominated and elected;

(C) A State (or political subdivision thereof) has fiscal responsibility for the general debts and other liabilities of the entity, including responsibility for the funding of benefits under the entity's employee benefit plans;

(D) The entity's employees are treated in the same manner as employees of the State (or political subdivision thereof) for purposes other than providing employee benefits (for example, the entity's employees are granted civil service protection); and

(E) In the case of an entity that is not a political subdivision, the entity is delegated the authority to exercise sovereign powers (which generally means the power of taxation, the power of eminent domain, and police powers) of the State (or political subdivision thereof) and the delegation of authority is pursuant to a statute of a State (or political subdivision thereof).

(ii) Other factors to be considered. In making the determination of whether an entity is an agency or instrumentality of a State or a political subdivision of a State, other factors include--

(A) The entity's operations are controlled by a State (or political subdivision thereof);

(B) The entity is directly funded through tax revenues or other public sources. However, this factor is not satisfied if an entity that is not otherwise an agency or instrumentality is paid from public funds under a contract to provide a governmental service or is funded through grants by the State or Federal government;

(C) The entity is created by a State government or political subdivision of a State pursuant to a specific enabling statute that prescribes the purposes, powers, and manners in which the entity is to be established and operated. However, a nonprofit corporation that is incorporated under a State's general corporation laws is not created under a specific enabling statute;

(D) The entity is treated as a governmental entity for Federal employment tax or income tax purposes (such as, the authority to issue tax-exempt bonds under section 103(a)) or under other Federal laws;

(E) The entity is determined to be an agency or instrumentality of a State (or political subdivision thereof) for purposes of State laws. For example, the entity is subject to open meetings laws or the requirement to maintain public records that apply only to governmental entities, or the State attorney general represents the entity in court under a State statute that only permits representation of State entities;

(F) The entity is determined to be an agency or instrumentality of a State (or political subdivision thereof) by a State or Federal court;

(G) A State (or political subdivision thereof) has the ownership interest in the entity and no private interests are involved; and

(H) The entity serves a governmental purpose.

(3) Examples. The following examples illustrate the application of this paragraph (f). In each of these examples, unless otherwise stated, only facts that are relevant to the examples are included and it is assumed that no party other than a State or political subdivision thereof has an ownership interest in the entity and that the entity serves a governmental purpose. The examples are as follows:

Example 1. (i) Facts. Entity C is a utility company located in County B of State A. Entity C is created pursuant to a State A statute by a petition of 25 private citizens who are landowners, and approved by an order of a judge in County B. Entity C is administered by a board of commissioners named in the original petition, with vacancies to be filled by the incumbents, but with State A having the right to remove a board member for malfeasance. Entity C has the power of eminent domain. In addition, the records of Entity C are public records.

(ii) Conclusion. Based on the facts and circumstances, Entity C is not an agency or instrumentality of County B within the meaning of paragraph (f) of this section because it does not satisfy the control factors described in paragraphs (f)(2)(i)(A) and (ii)(A) of this section because Entity C is under the control of a self-perpetuating board of directors and because State A or its officials do not exercise control over the directors.

Example 2. (i) Facts. The facts are the same as in Example 1, except that Entity C is administered by a board of commissioners which is appointed by the Governor of State A and is subject to removal proceedings by the Governor of State A, the County B prosecutor, or the general public in County B. Vacancies on Entity C's district board are filled by popular election or by appointment of the Governor of State A. Entity C has the power of eminent domain. In addition, the records of Entity C are public records.

(ii) Conclusion. Based on the facts and circumstances, Entity C is an agency or instrumentality of County B within the meaning of paragraph (f) of this section.

Example 3. (i) Facts. Entity K is a non-profit corporation that operates a zoo in County J. Entity K is organized under the laws of State L. Although Entity K was not created by State law, the legislature of State L authorized the State's forest districts to contract with zoological societies for the creation, operation, and maintenance of zoological parks. County J entered into a contract with Entity K, giving Entity K exclusive control and management authority over the zoo in County J. Entity K, through government contracts, receives over half of its revenues from taxes raised by County J. The remaining revenues are from admission and parking fees, concessions, souvenirs, and private donations. County J maintains a significant amount of control over the budget of Entity K, including overseeing the expenditures of nontax revenues generated by Entity K. The zoo is located on land owned by County J, and vehicles used at the zoo are owned by County J and licensed as municipal vehicles. Entity K is managed by a 35-member board of trustees. Only one member of the board of trustees is a public official. Of the 240 members of Entity K who elect the board of trustees, only 4 members are County J public officials. In addition, County J has no direct role in Entity K's operation and maintenance of the zoo. Employees of Entity K are not treated in the same manner as public employees and, thus, are not covered under the civil service rules, pension plan, or workers' compensation funds of County J or State L.

(ii) Conclusion. Based on the facts and circumstances, Entity K is not an agency or instrumentality of County J or State L within the meaning of paragraph (f) of this section. Although Entity K is partly funded by County J, it receives those funds under a contract to provide governmental service and very few members of both the board of trustees and the governing members of Entity K are public officials.

Example 4. (i) Facts. Entity P is a non-profit corporation that operates a 24-hour intermediate care facility for mentally challenged adults located in State O. Entity P is licensed and regulated by State O. While not created by statute, Entity P's facility was built pursuant to statutory directives. Entity P is managed by a 9-member board of directors, which consists of parents of the patients at the facility and other volunteers. The directors are elected by Entity P's corporate members. State O has no authority to appoint or remove directors. The facility is managed by an executive director who is hired by the board without State approval. Pursuant to regulations, State O mandates certain personnel requirements, including staffing levels and minimum qualification requirements for staff members at the facility. However, Entity P is responsible for hiring, firing, and other disciplinary decisions. State O prescribes an hourly mean wage

for the employees of Entity P, which limits the total amount that Entity P can pay its employees. In addition, State O imposes a ceiling on fringe benefits available to employees of Entity P, but Entity P is responsible for allocating the funds to pay for the fringe benefits.

(ii) Conclusion. Based on the facts and circumstances, Entity P is not an agency or instrumentality of State O within the meaning of paragraph (f) of this section. Although Entity P is directly funded by State O, it receives those funds under a contract to provide services to State O. Entity P does not satisfy the control factors described in paragraphs (f)(2)(i)(A) and (ii)(A) of this section because Entity P is controlled by directors who are chosen by Entity P's corporate members. While State O has some oversight control over Entity P's employees, through certification requirements and the imposition of limitations on pay and fringe benefits, Entity P has control over most employment decisions, as well as setting policies for holidays, vacations, insurance, and retirement benefits.

Example 5. (i) Facts relating to University U. University U was created by the legislature of State A and is an agency or instrumentality of State A under this paragraph (f). The board of trustees of University U appoints the president of University U. The president of University U appoints the chancellor of the medical school of University U. The chancellor of the medical school is also a vice-president of University U. The chancellor of the medical school appoints the various chairs of the clinical departments of the medical school.

(ii) Facts relating to the corporate structure of Employer M. The chairs of the clinical departments of the medical school have incorporated a separate entity, Employer M, under State A's not-for-profit law. Employer M is an integrated group practice for managing the clinical practice activities of the medical school faculty and was established in order to advance the purposes of the medical educational program and related activities of the medical school of University U. Under the by-laws of Employer M, any physician employee of Employer M must be a faculty member of the medical school (and if any physician employee of Employer M leaves the faculty of the medical school, his or her employment with Employer M terminates automatically).

(iii) Facts relating to the control of Employer M. Employer M is governed by a board of trustees consisting of the chancellor of the medical school, the clinical department chairs, and full-time faculty members appointed by two-thirds of the clinical department chairs. Performance of services as an employee of Employer M is a condition of employment for all full-time faculty members of the medical school. The faculty members are employees of University U and, in the capacity of their employment at University U, participate in the State A public employees' pension plan. Employer M also employs administrative and non-faculty employees who are not treated in the same manner as employees of State A (or University U). Employer M charges patients for the services provided by Employer M, and a portion of the fees collected are paid to University U. The compensation levels for employees of Employer M are set by faculty members who serve on the board of trustees of Employer M. The compensation paid to

faculty members by Employer M is a substantial portion of the total compensation paid to them by University U and Employer M. Audited financial records of Employer M are submitted annually to the president of University U.

(iv) Conclusion. Employer M does not satisfy any of the factors listed in paragraphs (f)(2)(i)(B) through (E) of this section (that is, its trustees are not publicly nominated and elected, State A has no fiscal responsibility for Employer M, administrative and non-faculty employees of Employer M are not treated in the same manner as employees of State A, and Employer M has no sovereign powers). Employer M also does not satisfy any of the additional factors listed in paragraphs (f)(2)(ii)(B) through (G) of this section, but does satisfy the governmental purpose factor in paragraph (f)(2)(ii)(H) of this section. With respect to the control factors in paragraphs (f)(2)(i)(A) and (ii)(A) of this section, while all of Employer M's trustees are employees of University U, the majority of the board of trustees is not controlled by University U but by clinical department chairs and full-time faculty members of University U. Their service on the board of trustees of Employer M is in their capacity as representatives of Employer M, not as representatives of University U or State A. Accordingly, based on the facts and circumstances, including the lack of involvement of University U in overseeing the conduct of the board of trustees and the operations of Employer M beyond review of its audited financials, Employer M is not an agency or instrumentality of State A within the meaning of paragraph (f) of this section.

Example 6. (i) Facts. Entity W, a private foundation, provides public assistance to the indigent elderly in a residence hall built on land privately donated to Entity W, located in City V. City V contracts with Entity W to provide elder care to residents of City V. Over the years, City V has regularly budgeted for services provided by Entity W to its residents, including maintenance and upkeep of its facilities, and salaries of employees. In 1970, Entity W and City V together incorporated a non-profit organization, Entity X, called "City V Eldercare Residence," through which Entity W would provide its services to the residents of City V. Under Entity X's bylaws, Entity X is governed by a board of directors, six of whom are appointed by the Mayor of City V, and six of whom are appointed by Entity W. Entity X's employees are considered employees of Entity X and are not treated in the same manner as municipal employees of City V.

(ii) Conclusion. Although City V is a political subdivision of a State within the meaning of paragraph (e)(1) of this section, Entity X is not an agency or instrumentality of City V within the meaning of paragraph (f) of this section. While Entity X satisfies the governmental purpose factor described in paragraph (f)(2)(ii)(H) of this section, it does not satisfy any other factor, including the control factors described in paragraphs (f)(2)(i)(A) and (ii)(A) of this section or the employee factor described in paragraph (f)(2)(i)(D) of this section (because a majority of the board is not appointed by City V and Entity X's employees are not treated in the same manner as employees of City V).

Example 7. (i) Facts. Five States created Commission D as a body corporate of each compacting State and territory. Commission D was created to provide services to

the States on issues relating to higher education. Each governor of the five States appoints three persons to the governing board of Commission D, which is subject to the joint control of the five States. Commission D submits yearly reports and budgets to the governors of each of the five States. Commission D's operating costs are apportioned equally among the States. The IRS determined in a ruling that Commission D was exempt from gross income under section 115. The IRS also determined that Commission D was an instrumentality of each of the five States for employment tax purposes.

(ii) Conclusion. Based on the facts and circumstances, Commission D is an agency or instrumentality of each of the five States within the meaning of paragraph (f) of this section.

Example 8. (i) Facts. Entity S, incorporated under the laws of State T as a non-profit corporation, operates a hospital in City R. City R leases the hospital and its entire operation to Entity S. The lease between City R and Entity S requires Entity S to transfer its assets and liabilities back to the City upon expiration of the lease. City R created the first board of directors for the hospital, but it does not have the power to remove or replace any board member. Only one of the 13 board members of Entity S is a public official, an ex officio voting member. In addition, the board of directors is not elected by the general public of City R. To fund a subsequent expansion of the hospital facility, City R issued tax-exempt bonds. Entity S does not have the authority to issue tax-exempt bonds. Entity S does not exercise any sovereign powers. Employees of Entity S are not treated in the same manner as employees of City R. For example, Entity S and City R maintain separate payrolls, health insurance plans, and pension plans.

(ii) Conclusion. Based on the facts and circumstances, Entity S is not an agency or instrumentality of City R within the meaning of paragraph (f) of this section. Although City R had the power of the initial appointment of the board members, it cannot subsequently appoint or remove any directors of Entity S, therefore, Entity S does not satisfy the control factor described in paragraph (f)(2)(i)(A) of this section.

(g) Special rules for plans of Indian tribal governments. [Reserved].

(h) Special rules for plans subject to the Railroad Retirement Act of 1935 or 1937. [Reserved].

(i) [Reserved].

(j) Special rules for plans subject to the International Organizations Immunities Act. [Reserved].

(k) Established and maintained--(1) In general. For purposes of applying this section (and not for any other purpose) with respect to a governmental entity (which is an entity defined in paragraph (b), (c), (d), (e), or (f) of this section), a plan is established and maintained for the employees of a governmental entity if--

(i) The plan is established and maintained for employees by an employer, within the meaning of §1.401-1(a)(2);

(ii) The employer is a governmental entity; and

(iii) The participants covered by the plan are employees of that governmental entity.

(2) Changes in status--(i) Ceasing to be a private entity. If an employer becomes a governmental entity (for example, as a result of a stock acquisition) or a governmental entity becomes the employer under the plan (for example, in connection with an asset transfer), the plan (including all of the plan's assets and liabilities attributable to service before and after the date of the change) will be treated, for purposes of paragraph (k)(1)(i) of this section, as being established by that governmental entity on the date of that change.

(ii) Ceasing to be a governmental entity--(A) General rule. Except as provided in paragraph (k)(2)(ii)(B) of this section, if an employer that is a governmental entity ceases to be a governmental entity (for example, as a result of a stock acquisition) or a private entity becomes the employer under the plan (for example, in connection with an asset transfer), the plan (including all of the plan's assets and liabilities attributable to service before and after the date of the change) is treated, for purposes of paragraph

(k)(1)(ii) of this section, as being established by the non-governmental employer on the date of that change.

(B) Exception. If a plan is established and maintained for the employees of a governmental entity in accordance with paragraph (k)(1) of this section (without regard to this paragraph (k)(2)(ii)) and, at a subsequent date, the employer ceases to be a governmental entity (for example, as a result of an assets transfer), the plan is treated as continuing to be a governmental plan if--

(1) A governmental entity continues to be the plan sponsor after the change (for example, a governmental entity assumes the plan on or before the date on which the private entity becomes the employer (including becoming responsible for the employer obligations with respect to the payment of benefits under the plan)); and

(2) Benefits under the plan are frozen (with, if provided under the plan, participating employees to receive credit for service with the new employer for purposes of vesting, final pay adjustments, entitlement to benefits such as early retirement benefits, and similar service credit other than benefit accrual credit).

(C) Governmental liability for spun-off benefits. In the case of a transaction such as an asset sale in which assets and liabilities of a governmental plan are transferred to a private plan, the private employer would be responsible for satisfying the minimum funding standards of section 412 (including with respect to benefits attributable to service performed before the date of the change). However, nothing in this paragraph (k)(2)(ii) should be construed to mean that, with respect to such a transaction, the assumption of benefit liabilities accrued prior to the transfer to the private plan would

relieve the former governmental employer (or former governmental plan) from responsibilities for those benefits.

(3) Plan coverage for employees of a labor union or plan. For purposes of paragraph (k)(1)(iii) of this section, employees of employee representatives described in section 413(b)(8) (including employees of a plan) are treated as employees of the plan sponsor. See §1.413-1(i).

(4) Examples. The following examples illustrate the application of this paragraph (k):

Example 1. (i) Facts. Employer C, a non-profit corporation whose principal place of business is located in City F, is not a governmental entity. Plan B, a retirement plan, is established and maintained by Employer C. In a stock acquisition, City F acquires all the shares of stock of Employer C and, as a result, Employer C becomes a governmental entity.

(ii) Conclusion. After the acquisition, Plan B is established and maintained by a governmental entity. In addition, the employees covered by Plan B are employees of a governmental entity. Thus, Plan B, including the assets and liabilities attributable to benefits accrued in Plan B prior to the date of the acquisition, is a governmental plan within the meaning of section 414(d) and this section.

Example 2. (i) Facts. Employer G is a hospital that is an agency or instrumentality of State A. Plan J, a retirement plan, is established and maintained by Employer G. Plan J satisfies the requirements of this paragraph (k) and is a governmental plan within the meaning of section 414(d). The assets of Employer G are transferred to a non-profit corporation, Employer M, which is not a governmental entity. All employees of Employer G become employees of Employer M. As part of the transaction, Employer M assumes Plan J, with respect to benefits accrued for service both before and after the transaction.

(ii) Conclusion. Plan J is no longer maintained by a governmental entity. In addition, the employees covered by Plan J are no longer employees of a governmental entity. Therefore, Plan J no longer constitutes a governmental plan within the meaning of section 414(d) and this section. In order for Plan J to continue to be a qualified plan, Plan J must satisfy the qualification requirements relating to non-governmental plans, including with respect to the assets and liabilities attributable to benefits accrued in Plan J prior to the date of the sale. The same conclusion would apply if the transfer were a stock transaction.

Example 3. (i) Facts. Same facts as in Example 2, except that, on the date of the sale, Employer G freezes Plan J, so that participants in Plan J are no longer accruing benefits under the plan and all accrued benefits are limited to service before the sale. In addition, on the date of the acquisition, State A assumes Plan J, including responsibility for the payment of benefits previously accrued to participants in Plan J.

(ii) Conclusion. In accordance with paragraph (k)(2)(ii)(B) of this section, Plan J continues to be a governmental plan within the meaning of section 414(d) and this section.

Example 4. (i) Facts. Pursuant to a State statute, State L permits local towns and villages to establish recreational facility authorities to build and promote recreational activities. Under Statute K, unincorporated Townships M, N, and O (which are political subdivisions of State L, within the meaning of paragraph (d) of this section) jointly establish a recreational facility authority, Authority R. Financing for Authority R is through local taxes and fees. Authority R operates under a three-person board of directors, one each appointed by townships M, N, and O. Authority R built and operates a skating rink, Facility S, which is located in Township O, but is open to the residents of Townships M, N, and O. Facility S is wholly owned and controlled by Townships M, N, and O. Township O maintains Pension Plan P for its seven employees, which is a governmental plan under section 414(d). Township O amends its plan to permit the three employees of Facility S to participate. The employees of Facility S are not employees of Township O and are not employees of a labor union described in section 413(b)(8).

(ii) Conclusion. The governmental plan status of Pension Plan P is not affected by the participation of Facility S's employees because Facility S is a governmental entity within the meaning of section 414(d) and this section.

Example 5. (i) Facts. Same facts as Example 4, except that Township O amends Plan P to permit participation by 10 employees of candy and soft drink Vendor T, a supplier for Facility S. Vendor T is not a governmental entity.

(ii) Conclusion. Plan P is no longer a governmental plan within the meaning of section 414(d) because it provides benefits to employees of a non-governmental employer, Vendor T.

(l) Employee. For purposes of this section, the term employee means a common law employee of the employer (and the rules in section 401(c) do not apply).

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